8/7/87 A-7870-3

NFPA AN ECONOMICS BULLETIN OF THE FOREST PRODUCTS INDUSTRY

# ECONOMICS MONTHLY

Volume III Number 7 July, 1987

## THE TIMBER BUYOUT REVISITED

Two years after Congress passed the Federal Timber Contract Payment Modification Act of 1984 (FTCPMA), a substantial volume of "high-priced" timber purchased before 1982 has yet to work its way through the system. A significant portion of this volume is not yet profitable to harvest and may never be. Producers will soon face hard decisions about blending these volumes in with newer, presumably more profitable timber, or incur liabilities from defaults. Defaults on federal timber contracts increased dramatically last year, particularly on pre-1982 contracts.

Under the FTCPMA, timber purchased from the federal government prior to January 1, 1982 was eligible to be returned after payment of a buyout fee. The Act allowed purchasers to buy out of 55 percent of unharvested volume they held under pre-1982 contracts, up to as much as 200 million board feet. The buyout payment ranged from $10 per thousand board feet (MBF) to 15 percent of the original overbid (the Act set up a financial hardship test to determine the buyout fee). Approximately 18.6 billion board feet under contract was eligible for the buyout by virtue of its purchase date. By October, 1985, a total of 1,848 contracts representing nearly 11 billion board feet, were returned to the Forest Service and BLM, with a total payment of $182 million.

### Region 6 and BLM

As a follow-up to a story we ran in the April, 1986 issue of Economics Monthly on the aftermath of the buyout legislation, we recently examined the current status of pre-1982 contracts. For this analysis, we looked at Forest Service Region 6 and the BLM, which accounted for the lion's share of the high-priced contracts, and for which data were compiled. On December 31, 1985, 5.1 billion board feet of volume in pre-1982 contracts still remained in Region 6 and the BLM. As of that date, this represented a $770 million liability to purchasers holding the contracts.

Volume data for both Region 6 and BLM were again analyzed for net value a year later, on December 31, 1986. At then-current market prices, about two-thirds, or 3.4 billion board feet, still remained in these contracts, representing a potential liability of over $388 million.

Table I shows estimates of net value represented by the volume held by purchasers at the close of 1986. Net value is defined as the delivered log value minus the delivered log cost estimated for each of the identified 662 pre-1982 sales. Thirteen percent of the volume (441 million board feet) would return a profit, according to this analysis. Interestingly, most of this positive net-valued volume is on the East Side of Region 6,

**MONTHLY STATISTICAL HIGHLIGHTS**

May's softwood lumber production fell 3.1 percent from April, but was up 3.5 percent from a year ago.

New orders for softwood lumber rose 7 percent in May, while gross stocks declined by nearly 2 percent.

Softwood lumber consumption was running 5.3 percent ahead of last year during the first five months of 1987.

The Commerce Department reports that U.S. manufacturing labor productivity rose 3.5 percent during 1986, outpacing other industrial countries for the first time in three decades.

The Department of Commerce reports that expenditures on residential properties totaled $91,274 million in 1986. This compared with $80,267 million in 1985, and $69,784 million in 1984.

Copyright 1987, National Forest Products Association, 1250 Connecticut Avenue, NW, Suite 200, Washington, D.C. 20036 (202) 463-2714. All rights reserved. Information and data collected and compiled by NFPA may not be reproduced, offered through any retrieval system or data bank, or otherwise circulated for resale without prior written permission by NFPA.

where strong Ponderosa Pine markets have buoyed stumpage prices.

In contrast, losses on over 60 percent of the remaining volume exceeded $75 per thousand board feet on December 31, 1986. Given current and prospective market conditions, it is unlikely that all of the losses represented by these contracts will disappear before the timber is harvested. Losses representing an excess of $150 per thousand board feet make up over a third of the total volume, with purchasers of these contracts standing to lose over $270 million, based upon December, 1986 market values. Even with the 20 percent increase in lumber prices this year, this volume still represents a significant loss, and is unlikely to prove economically viable by itself.

Most of the losses represented by the pre-1982 contracts tend to be concentrated with a small number of purchasers. Table II shows this distribution, and suggests that nine purchasers each stand to lose over $10 million on those contracts. They hold over half of the volume in the total, representing two-thirds of the total loss.

**Table I:** Pre-1982 contracts represent as much as $388 million in losses for purchasers.

Volume in Pre-1982 Contracts
by Net Value Per MBF

Region 6 and BLM

| Net Value ($/MBF) | Volume MMBF | Total Net Value ($ Mil) |
|---|---|---|
| greater than 0 | 441 | 17.5 |
| 0 to -75 | 835 | -31.4 |
| -75 to -150 | 913 | -101.0 |
| -150 to -225 | 789 | -146.9 |
| less than -225 | 454 | -126.9 |
| Total | 3,431 | -388.6 |

Source: Timber Data Company; NFPA

**What to Do -- Purchaser Options**

Purchasers holding an unprofitable contract face two unappealing options. They can either operate the contract and try to absorb the loss, or default the contract.

Prior to passage of the FTCPMA, the Forest Service allowed purchasers to extend the expiration date of sales purchased before 1982 by up to five years. The notion behind the Multi-Sale Extension Program was that purchasers could "blend" losses from the harvest of old, unprofitable sales with profits from the harvest of newer sales bid at more reasonable rates. The Reagan Administration hoped that the contract extension program would help companies to recover from the liabilities of the high-priced contracts without forcing them into bankruptcy.

The extension program stretched the contract expiration dates to as far as 1991. The bulk of the volume is due to expire during 1989. Whether or not a purchaser can successfully blend the timber from these older, high-priced contracts with timber from more recent sales depends upon whether the margins from the newer contracts are great enough to offset the losses on the old contracts. Unfortunately, keen competition for volume offered for sale over the last couple of years has kept margins low, thereby making it difficult for many purchasers to offset substantial losses on the old contracts.

**Defaults During 1986**

Faced with considerable losses from operating unprofitable contracts, some purchasers have already turned to the option of defaulting timber sales. Since 1982, approximately 2 billion board feet of federal timber has been defaulted; this is extremely high by

historical standards. Some 311 purchasers defaulted on 613 individual sales, so defaults are not only a problem for just a handful of companies. Most of the defaulted volume -- 1.6 billion board feet -- was defaulted during fiscal year 1986. Of the total, Region 6 and BLM accounted for 1.2 billion board feet, with almost 1 billion board feet of that amount accounted for by pre-1982 contracts. Producers would have incurred losses totaling more than $160 million had they harvested the defaulted volume, paid for it at the bid price, and sold it at current log prices.

Net Value of Portfolios of Pre-1982 Contracts
Region 6 and BLM

| Net Value/Portfolio ($ Mil) | No. of Purchasers | Tot. Vol. (MMBF) | Tot. Net Value ($ Mil) |
|---|---|---|---|
| greater than 0 | 26 | 370 | 13 |
| 0 to -1 | 43 | 414 | -14 |
| -1 to -10 | 33 | 976 | -132 |
| -10 to -25 | 7 | 867 | -110 |
| less than -25 | 2 | 804 | -146 |
| Total | 111 | 3,431 | -389 |

Source: Timber Data Company; NFPA

**Table II:** As many as 85 purchasers may suffer losses from pre-1982 contracts.

Several reasons for the defaults during 1986 could be identified. Approximately half the volume, or 780 million board feet, was held by purchasers involved in some kind of bankruptcy proceeding. Other defaults were attributable to a failure to fill some contractual obligation such as an interim payment, to not being included in a Multi-Sale Extension Plan, or because a particular company went out of the business altogether.

**Unclear Whether Further Defaults Are Imminent**

How much of the pre-1982 volume will ultimately be harvested and how much will be defaulted is largely a matter of speculation. The timing of future harvests or defaults is suggested by looking at the distribution of the volume in old sales by contract expiration date. For example, Figure 1 shows that almost half of the remaining volume is in contracts that expire in 1989. Of that amount, over 1.0 billion board feet represents a potential loss -- of at least $75 per MBF if calculated based on December 31, 1986 markets.

For contracts coming due this year -- in 1987 -- losses on as much as 160 million board feet can be expected. This volume represented a loss in excess of $75 per MBF on December 31, 1986, a loss which would likely be realized even in today's more favorable economic climate. Looking to 1988, there is over 360 million board feet, or 80% of the volume expiring next year, which represents a similar loss.

**Defaulting Is Not Without Its Problems**

Aside from market conditions, other factors will influence a company's decision whether or not to default a federal timber contract. Defaulting on a federal timber sale is becoming increasingly costly and risky. First, purchasers defaulting Federal timber sale contracts are liable for damage assessments that equal the difference between the original bid price of the sale and the resale value, plus the administrative costs of re-offering the sale. Purchasers defaulting timber sales are in effect gambling that the resale value of the timber sale will be high enough that the damage assessment will be less than the loss experienced by harvesting the sale at the original bid price.

Secondly, a purchaser may also find it more difficult to enter into new contracts if he defaults any Federal timber sales. In a April 10, 1987 letter, the Chief of the

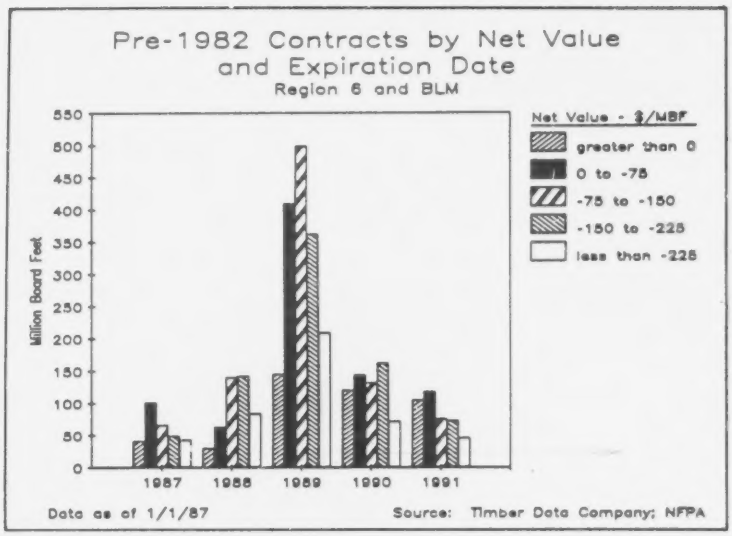


**Figure 1:** Most of the volume in pre-1982 timber contracts is due in 1989, and represents substantial losses.

Forest Service directed the Regional Foresters to evaluate more rigorously whether a bidder will be able to operate a timber sale before awarding the contract. Part of the evaluation consists of determining the impact of outstanding default assessments on the purchaser's net book worth. If the net book worth is less than the purchaser's total potential liability for default damages on all Federal timber sale contracts, the purchaser will be considered financially irresponsible, and will not be awarded the timber sale contract.

Lastly, and most significantly, the Forest Service has proposed new contract provisions which would restrict the ability of purchasers who have defaulted on previous sales to enter into new contracts. The agency is considering doubling the down payment requirements on new sales for those purchasers. The BLM has already established similar procedures. Some purchasers, therefore, may find that it is more advantageous to absorb the loss on some sales than to jeopardize their ability to secure new sale volume in the future.

**Decisions To Be Made Before 1989**

In many cases, the decision to harvest or default will be made during the year before the contract comes due. This is because certain provisions of the Multi-Sale Extension Program requires harvesting some timber before the contract due date, and because about one third of the pre-1982 contracts expire at the end of the first quarter of the calendar year. Since the harvest plans for these contracts usually specify that the volume must be harvested by the end of the previous calendar year, a sale would essentially be operated (or go into default) at the end of the operating season of the year previous to the expiration year.

Therefore, the status of much of the volume expiring in 1989 will be known sooner, in either 1987 or 1988.

**Wrap-Up**

In summary, over 3.4 billion board feet remained in sales bid prior to 1982 at the beginning of 1987. At least 2.1 billion board feet of that volume is unlikely to be economic to harvest, and would therefore result in losses of over $375 million to purchasers holding those contracts. While about half of that volume is in contracts which expire in 1989, purchasers that decide to default or harvest that volume will probably do so in 1987 and 1988.

NOTE: Last month's story about the Conservation measures of the 1985 Farm Bill was based in large part on two papers: Moulton & Dicks, "Implications of the 1985 Farm Act for Forestry", and American Farmland Trust, "Impacts of the Conservation Reserve". Copies of both papers are available by calling 202/463-2714.